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Possible future work in security interests

Security interests

Note by the Secretariat

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I. Introduction

1. The topic of secured transactions has long been of interest to the Commission.[1] In the late 1970s, the United Nations Commission on International Trade Law (UNCITRAL) considered the first studies in that area of law.[2] Those studies led to the suggestion by the Secretariat that the preparation of a model law would be both desirable and feasible (see A/CN.9/165, para. 61). At its thirteenth session, in 1980, the Commission considered a note by the Secretariat, which discussed issues to be addressed and made suggestions as to possible solutions.[3]

2. However, at that session, the Commission concluded that worldwide unification of the law of security interests in goods was in all likelihood unattainable. The Commission was led to that conclusion by the concern that the subject was too complex and the divergences among the different legal systems too many, as well as that it would require unification or harmonization of other areas of law, such as insolvency law, which at that time appeared to be impossible. During the discussion at that session, it was noted that it was advisable for the Commission to await the outcome of the work of other organizations, such as the International Institute for the Unification of Private Law (Unidroit), which was in the process of developing a convention on international factoring (which was finalized in 1988 and entered into force in 1995).

3. It was on the occasion of the UNCITRAL Congress on Uniform Commercial Law in the Twenty-first Century, held in New York in conjunction with the twenty-fifth session of the Commission, in 1992,[4] that the need for UNCITRAL to resume its work on secured transactions was mentioned again.[5]

4. That need has been reiterated in conferences throughout the world over the last few years and has attracted the attention of legislators at the international, regional and national levels, as well as of international and regional financial institutions, such as the European Bank for Reconstruction and Development (EBRD), the International Bank for Reconstruction and Development (World Bank) and the Asian Development Bank (ADB). With a view to informing the Commission about current activities in the field of security interests, facilitating coordination of efforts and assisting the Commission in its consideration of the matter, a current activities report was presented to the Commission at its thirty-third session, in 2000 (A/CN.9/475), in which not only the Commission's earlier work on security interests and the developments in the area of security interests law in the last 25 years were considered, but problems were also identified and suggestions made as to possible areas for future work.

5. When discussing the report at its thirty-third session, the Commission emphasized that it was the right time to start work on secured transactions, in particular in view of the close link between security interests and the ongoing work of the Commission on insolvency law. It was widely felt that modern secured credit laws could have a significant impact on the availability and the cost of credit and thus on international trade. It was also stated that modern secured credit laws could alleviate the inequalities in the access to lower-cost credit between parties in developed countries and parties in developing countries and in the share such parties had in the benefits of international trade. A note of caution was struck to the effect that such laws needed to strike an appropriate balance in the treatment of privileged, secured and unsecured creditors so as to become acceptable to all States. It was also stated that, in view of the divergent policies of States, a flexible approach aimed at the preparation of a set of principles with a guide, rather than a model law, could constitute a workable alternative.[6]

6. A number of suggestions were made as to the focus of the work to be undertaken. One suggestion was to deal with security interests in securities (e.g. stocks, bonds, swaps and derivatives). Such securities, which were held as entries in a register, by an intermediary and, physically, by a depository institution, were important instruments on the basis of which vast amounts of credit were extended not only by commercial banks to their clients but also by central banks to commercial banks. It was also observed that, in view of the globalization of financial markets, a number of jurisdictions were normally involved, the laws of which were often incompatible with each other or even inadequate to address the relevant problems. As a result, a great deal of uncertainty existed as to whether investors owning securities and financiers extending credit and being granted a security interest had a right in property and were protected, in particular, in the case of the insolvency of an intermediary. It was also pointed out that a great deal

of uncertainty arose even as to the law applicable to security interests in securities held by an intermediary and the fact that the Hague Conference on Private International Law planned to address that matter indicated both its importance and its urgency. In that regard, it must be pointed out that work by the Commission would be compatible with, and could usefully supplement, any work undertaken by the Hague Conference, since the work of the Commission would focus mainly on substantive law aspects whereas the Hague Conference's efforts relate to private international law.[7]

7. Another suggestion made was to deal with security interests in inventory (i.e. a changing pool of tangible movable assets). It was stated that the use of a changing pool of assets, whether tangible or intangible, was an important feature of modern secured financing law. It was also observed that any work on inventory could usefully draw on the Commission's work on receivables and on practices that would be likely to draw a positive response from international financial markets. The following were mentioned as matters that would need to be addressed in such a uniform law: the creation and scope of a security interest (which should include property acquired, and secure debts arising, even after the creation of the interest); remedies upon default of the debtor; clear priority rules; and mechanisms ensuring the transparency of any interest.[8]

8. Yet another suggestion was that a uniform law should consider the establishment of an international registry of security rights. Such a registry would enhance certainty and transparency and, as a result, have a positive impact on the availability and the cost of credit. It was felt that that result could be most easily achieved if the register encompassed all types of security interest in all types of asset.[9]

9. After discussion, the Commission requested the Secretariat to prepare a study that would discuss in detail the relevant problems in the field of secured credit law and the possible solutions for consideration by the Commission at its thirty-fourth session, in 2001. It was agreed that, after considering the study, the Commission could decide at that session whether further work could be undertaken, on which topic and in which context. It was further agreed that the study could discuss the advantages and disadvantages of the various solutions (i.e. a uniform law on all types of asset as opposed to a set of principles with a guide or a uniform law on specific types of asset). Moreover, it was agreed that the study should draw upon and build on work carried out by other organizations and that any suggestions should take into account the need to avoid duplication of efforts.

10. The present study has been prepared pursuant to that request by the Commission and is intended to facilitate the Commission's consideration of, and decision on, future work in the area of secured transaction law. After some introductory remarks on the reasons why one resorts to secured lending, the study will briefly discuss the relationship between insolvency law and the law on security rights. It will then address issues pertaining to the development of model legislative solutions on security rights in general, as well as issues relating to the drafting of asset-specific model legislation, in particular model legislation concerning securities and intellectual property rights. The final chapter is dedicated to issues of private international law.

II. Economic importance of secured lending

11. For the last few years, many policy makers have been seeking to modernize the rules dealing with the granting of security interests to creditors in order to promote commerce. In that respect it suffices to mention that, in 1999, the United States of America thoroughly revised article 9 (which deals with security interest) of its Uniform Commercial Code and both New Zealand and Romania enacted broad statutes on personal property security interests, introducing modern rules dealing with secured transactions. Other countries, such as Bulgaria (1996), Chile (1982), Greece (2000), Indonesia (1999), Latvia (1998), Lithuania (1997), Montenegro (1996) and Poland (1996), also enacted legislation dealing with the issue of security interests (albeit differently than the aforementioned ones).

12. The above references show that there is a clear trend towards the modernization of the legal regime relating to security interests. When drawing up such a modern regime, the reasons for parties resorting to the granting of security interests have to be taken into account. Merely stating that granting security interests lowers the aggregate costs of lending transactions does not appear to explain the phenomenon sufficiently,

since, as pointed out by other commentators, secured lending is not ubiquitous, that is, many lenders/creditors do not secure all of their credit or do not secure their credits at all. Explaining why secured lending is—or is not—an efficient practice may be of assistance to the Commission's efforts in that area of the law. Indeed, bearing in mind the reasons that motivate the use of security interests may assist the drafters of future legal instruments.

13. To understand these motivations, it is necessary to examine the perceptions of the parties involved in the credit market that lead them to resort (or refrain from resorting) to secured lending.

14. The advantages that a creditor receives from a grant of security interests can lower its anticipated overall costs and thus indirectly lower the costs that the debtor must pay to induce the creditor to give credit. Two different types of advantages can be distinguished: direct ones and indirect ones. The most obvious direct advantage for the secured lender is that obtaining security increases the likelihood of payment in the event of default. Commentators have identified three different ways to enhance the secured lender's ability to enforce payment: by obtaining security, by granting priority (so that the lender will be paid before other creditors) and by enhancing the lender's remedy (so that the lender can coerce payment more quickly than it could if its debt were not secured). If the lender believes when it gives credit that those advantages increase the likelihood of repayment, it can charge less for the credit, thus lowering the aggregate costs of the transaction.

15. There are other, more indirect, advantages for the secured lender. For example, the grant of a security interest to the creditor is said to enhance its ability to limit subsequent borrowings, increase the debtor's incentive to attempt to repay the loan voluntarily and facilitate restraint of the debtor's risky conduct.

16. As far as the creditor's ability to limit subsequent borrowings is concerned, it is based upon the assumption that the debtor will pay more attention to its business if it has a more substantial stake in the business. By restricting the debtor's ability to obtain large loans in the future, the creditor restricts the debtor's ability to decrease its interest in the business, as long as the creditor also can limit the debtor's ability to sell its ownership interest in the business. Of course, the legal rights that constitute a grant of collateral do not directly bar subsequent borrowings, but a grant of collateral can restrict the debtor's ability to obtain future loans by reducing its ability to grant a valuable security interest to subsequent lenders. It is that limitation that may make future borrowings relatively expensive (and thus less attractive) for the debtor.

17. Another advantage is the leverage given to the creditor by way of the grant of collateral, which increases the borrower's incentive to repay the debt. That leverage of the secured creditor depends on the increased likelihood of the creditor being able to enforce its claim efficiently.

18. A further advantage is the creditor's enhanced ability to prevent the debtor from engaging in risky conduct that—in the creditor's view—could lead to a decrease of the debtor's ability to pay the debt. Since unsecured lending transactions generally allocate to the creditor a substantial part of the risk of loss in the event the debtor's business fails, the debtor may indeed have a higher preference for risk-taking than it would have if it bore all of the risks of failure. This may, on the one hand, diminish the likelihood that the debtor will pay the debt, and, on the other, increase the costs of the transaction. Thus, secured lending mechanisms that narrow that gap can decrease the costs of the transaction by lowering the creditor's pre-credit assessment of the risk of non-payment.

19. The main advantage for the borrower lies in the fact that the more a commercial enterprise is able to use the value inherent in its assets as collateral for a loan, the greater is the likelihood of lowering the cost of it obtaining credit.

20. However, secured lending also gives rise to costs that do not exist in unsecured lending. These are linked mainly to the costs of concluding the secured transaction and to the costs of administering credits. Three types of the former kind of cost can be identified: information costs (such as the costs of acquiring information about the value of the collateral and the debtor's title to it), documentation costs (although a grant of collateral generally does not have a significant effect on the costs of documentation, since all transactions involve some kind of documentation costs; this may not be true where the transactions involve unusual, varied or widely dispersed collateral, although it is also possible to imagine unsecured transactions with particularly high documentation costs) and, where

applicable, filing fees and taxes (i.e. a distinct expenditure incurred solely because of the decision to secure the transaction; it should be noted that compliance with the filing requirement, where applicable, includes not just the actual filing fee, but also all of the costs associated with determining exactly what to file and where to file).

21. As far as the costs of administering credits are concerned, it appears that the large amounts of time and money that creditors and debtors spend administering secured transactions constitute a significant cost of secured credit. Both transaction and administration costs depend to a large extent on the legal regime governing the transaction; any attempt to create a uniform regime aimed at promoting the availability of credit at lower cost should take this into account.

III. Insolvency law and law on security rights

22. The laws relating to security rights, on the one hand, and to insolvency, on the other, have different objectives. Security rights laws are designed to protect the creditor extending secured credit to a debtor, whereas the insolvency laws are designed to provide for the orderly liquidation or rehabilitation of a debtor in a manner that is fair, not only to its secured creditors, but to all of its creditors. Thus, it is not surprising that the two subjects are generally dealt with under separate legal regimes.

23. However, there is a significant interrelationship between the two regimes, arising from the fact that a security right is of little or no value to a secured creditor if it is not ultimately enforceable against third parties, including the debtor's insolvency administrator. That is not to say that the insolvency regime of a given jurisdiction must recognize an unconditional and immediate right of secured creditors to enforce that right in order to induce them to provide financing in that jurisdiction. On the contrary, it has been observed that secured creditors generally require only that the insolvency regime be sufficiently fair and predictable to instil in them the belief that their security rights, if properly created, will ultimately be enforceable against the collateral within a reasonable time frame, without excessive cost and without being subject to unanticipated competing claims.

24. The development of an appropriate insolvency regime requires the establishment of various mechanisms designed to achieve a balance between the interests of the insolvency administrator and protection of the rights of secured creditors. One mechanism for assisting in the liquidation or rehabilitation of a debtor is a stay of enforcement actions by creditors against the debtor and its property. In some jurisdictions, the stay is triggered automatically upon the commencement of the insolvency proceeding, while in other jurisdictions it may only be invoked at the discretion of the insolvency tribunal. To a certain extent, the stay of actions against the debtor may also work in the interest of the debtor's secured creditors, who may be interested in avoiding the dismemberment of the debtor's business.

25. Another mechanism aimed at achieving that balance is the ability of the insolvency administrator to challenge, and ultimately to set aside or subordinate, certain security rights and other transactions on the ground that they result in unjustifiable preferential treatment of certain creditors, that they are actually or constructively fraudulent or otherwise unenforceable or inequitable. A third mechanism would be to provide compensation to the secured creditor to avoid diminution of the value of the collateral, whether arising from the imposition of the stay or use of the collateral by the debtor. Possible approaches would include protecting the value of the collateral or protecting the secured portion of the secured creditor's claim in the insolvency. Protection of the value of the collateral could involve a number of steps: providing compensation for depreciation; payment of interest; protection and compensation for use; and lifting of the stay of actions. Another approach would be to protect the value of the secured portion of the claim. Immediately upon commencement, the encumbered asset is valued and, based on that valuation, the value of the secured portion of the creditor's claim is determined. That value remains fixed throughout the proceedings and, upon distribution following liquidation, the secured creditor receives a first-priority claim to the extent of that value. During the proceedings, the secured creditor could also receive the contractual rate of interest on the secured portion of the claim to compensate for delay imposed by the proceedings.

26. However, it has been observed that the existence of mechanisms that may affect a creditor's ability to deal with its collateral will not generally deter a lender

from extending credit as long as the lender can develop a sufficient degree of comfort that the insolvency laws will be enforced in a reasonably predictable and transparent manner, that the lender will be compensated in a fair way for the diminution in value of its collateral and that the lender will ultimately be able to realize upon its collateral within a reasonable period of time.

27. It should be noted that there is another potential interrelationship between security rights laws and insolvency laws. Under the insolvency laws of some jurisdictions, opportunities exist for a creditor to facilitate the rehabilitation of the debtor by providing financing to the debtor during the insolvency proceeding (thereby potentially enhancing the recovery for all of the creditors) and to obtain for that post-insolvency financing a special security right or priority. Often, such financing is provided by the creditor who provided financing to the debtor prior to the commencement of the insolvency proceeding. In such situations, security rights laws and insolvency laws can work together towards a common goal.

28. Because of the strong interrelationship between the secured lending laws and insolvency laws, all efforts on those laws should be closely coordinated, in particular as far as the stay of actions and the protection of the diminution of value is concerned. In addition, because of the critical requirement that properly created security rights be enforceable in preference to other creditors of the debtor and remain effective in insolvency proceedings, it is suggested that any legislative guide address the issue of the relationship between contractual security interests and statutory privileges, such as tax privileges.

IV. Legislative guide on security rights in general

29. One of the most efficient ways of obtaining working capital is pursuant to secured loans. The more a commercial enterprise is able to use the value inherent in its assets as collateral for a loan, the greater is the likelihood of lowering the cost of obtaining credit.

30. No matter how valuable a particular item of property may be to a commercial enterprise, it will have little or no value to a creditor as collateral for a loan unless the creditor is able to obtain a security right in the property that has priority over other creditors and remains effective in insolvency proceedings and that is capable of being enforced by the creditor in a predictable and timely fashion. The less time and expense that it takes to establish and enforce such a security right and the clearer a creditor's rights to its collateral are made, the more available and economical secured credit will be to commercial enterprises. Therefore, it is suggested that a legislative guide on security rights should aim at providing, to the extent possible, harmonized rules that would enable commercial enterprises to grant security rights in a wide range of asset types, allow creditors to be certain about the priority of their security rights against other creditors (including the priority of their security rights in insolvency proceedings) and make it possible for creditors to enforce their security rights, all in a timely, predictable and cost-efficient manner.

31. The present section outlines the main issues to be considered in developing a legislative guide on secured financing in general. Those issues are organized into three broad categories: (a) issues pertaining to the creation of security rights; (b) issues pertaining to priority of security rights; and (c) issues pertaining to enforcement of security rights.

A. Issues pertaining to the creation of security rights

32. The cornerstone of secured financing is the ability of a creditor to obtain a security right in the various types of property owned by the debtor.[10] From the creditor's perspective, such right should be both enforceable against the debtor as a matter of contract and have the requisite priority as against the debtor's other creditors, as well as remaining effective in insolvency proceedings. That concept actually represents a series of rights that are important to a secured creditor, many of which are seriously limited or uncertain under the existing laws of many countries, a circumstance that is not conducive to promoting secured financing in those countries.

1. Limitations on property that may serve as collateral

33. An important issue for consideration is whether a legislative guide on secured transactions should impose

any limitations upon the property that may serve as collateral for loans. As the exclusion of a given property type from serving as collateral for loans would deprive a debtor from obtaining secured financing based on the value of such property, careful consideration should be given before providing for any such exclusion.

34. In many countries, fixed assets such as real estate and equipment have traditionally served as the primary forms of collateral for secured financing. Fixtures, such as heavy equipment that is affixed to real estate, which have characteristics of both real estate and equipment, traditionally have also served as an important form of collateral. More recently, receivables,[11] inventory destined for further production or sale and investment securities,[12] have become increasingly important forms of collateral for secured loans in various countries. In the past decade there has been a trend in some countries towards loans secured by patents, trademarks, copyrights and other forms of intellectual property, which reflects the increasing importance of intellectual property as a component of the value of commercial enterprises (a trend in secured lending that is expected to continue).[13] It has been suggested that, if the goal of a legislative guide on secured financing is to promote secured financing, the guide should accommodate security rights in virtually all property of a commercial enterprise.[14]

35. A related issue is whether a legislative guide should permit security rights to extend to property that is not presently owned by the debtor. In many countries, a creditor is only able to obtain a security right in assets that are owned by the debtor at the time of the creation of the security right. Although that limitation works well for loans secured by real estate or equipment, it is generally not adequate for loans secured by assets that continually turn over, such as receivables and inventory of raw materials, unfinished products or finished products. It is generally viewed as being costly and administratively impractical for a creditor to amend its security documents with sufficient frequency to reflect the creation and collection of receivables and the acquisition and sales of inventory in the ordinary course of the debtor's business. It should be noted, in that connection, that the UNCITRAL draft convention on assignment of receivables provides that, unless otherwise agreed, a security right in receivables extends to future receivables, without the requirement of any further documentation or action on the part of the creditor or debtor.[15] A related issue is whether the security right already created can secure future advances of loans in addition to the loans already given.[16]

36. In the case of inventory financing, it has been observed that a security right in inventory that automatically extends to goods acquired after the creation of the security interest ("after-acquired" inventory) and secures future advances is essential to the concept of a revolving inventory loan facility, which is a highly efficient form of secured financing used in some countries. That type of loan facility is generally used by the debtor to finance its ongoing working capital needs. Under such a facility, advances are made from time to time at the request of the debtor, based upon a specified percentage of the value of the debtor's inventory. That percentage (generally known as the "advance rate") is determined by the creditor based upon the creditor's estimate of the amount it would realize on the inventory if it were to look to that inventory as a source for repayment of the loan. Typically, the advance rate ranges from 40 per cent to 60 per cent. If the inventory is located in a country that has unfavourable secured financing laws, the inventory may well be deemed ineligible for borrowing purposes. By matching borrowings to the debtor's cash conversion cycle (that is, acquiring inventory, selling inventory, creating receivables, receiving payments on the receivables and acquiring more inventory to begin the cycle again), the revolving inventory loan structure is, from an economic standpoint, highly efficient and generally considered to be beneficial to the debtor.

37. The question arises as to whether a security right that automatically extends to after-acquired property and automatically secures both existing and future advances should be limited to receivables and inventory or should also be permitted for other types of collateral, such as equipment or intellectual property. Commentators have suggested that there are no apparent policy reasons against such an extension and that in fact doing so would promote secured financing. Consideration may be given to whether the maximum amount of future advances that a security right can secure must be specified at the time the security right is created. That would allow other creditors to provide additional financing to the debtor based on the value of the same assets if the other creditors believe that the value of such assets exceeds the maximum amount of such future advances.

2. Description of collateral

38. Another important aspect concerns the flexibility given to the parties to describe specifically the assets that are given as security. In some legal systems, broad freedom is given to the parties in the description of assets that may be given as security. It is possible, for example, to create security that covers inventory of a constantly changing pool of products. Furthermore, in some legal systems it is possible to use as security the totality or a part of the assets of an enterprise without the need to list specifically the components of the asset, making it possible to sell the enterprise as a going concern. That may enable an enterprise in financial difficulties to be rescued while increasing the recovery of the secured creditor. Other legal systems, however, allow only the creation of security relating to specific assets and do not recognize security of inventory of goods without itemizing the components of the inventory. That requirement can be especially problematic in the case of a security right in inventory, receivables or intellectual property rights, where the requirement of specificity can make it impractical to obtain a security right in a constantly changing pool of receivables, a stock of inventory that turns over frequently or is comprised of many different products or intellectual property rights that are continually being refined and updated. It has been stated that the requirement that collateral be described with great specificity has resulted in the complete unavailability of inventory finance.[17]

39. In response to that problem, the laws of many jurisdictions only require that collateral descriptions contain enough detail reasonably to identify the property covered by the security right. For example, in some jurisdictions, a collateral description such as "all of the debtor's existing and after-acquired inventory" is sufficient. The latitude given to the parties in those jurisdictions avoids the need for the creditor to compile lengthy listings detailing each item of collateral.

40. Given its important implications in financing practice, provisions allowing the parties adequate flexibility in the description of assets would be a suitable solution in a harmonized text for universal use.

3. Non-possessory security rights

41. Secured creditors generally finance ongoing businesses and typically take as collateral assets that are used in those businesses. It is essential that debtors be able to retain possession of their property for use in their businesses. However, in the case of security rights in tangible personal property, the laws of many countries provide that the debtor must be "dispossessed" of such property if it is to serve as collateral—that is, the creditor must, either itself or through an agent, maintain physical possession of the property in order for the creditor to obtain a security right in the property that has priority over the debtor's other creditors and remains effective in insolvency proceedings. Such laws frequently render such property useless as collateral in situations where possession of the property by the debtor is essential for the operation of its business and thereby discourage or make impossible secured financing in those situations.

42. There are certain situations where such dispossession is not inconsistent with the debtor's business. For example, some distributors of goods may routinely store the goods in a public warehouse pending shipment to customers. In such a situation, the warehouse operator can agree, in some countries, to serve as the agent for the creditor, with the result that possession by the agent can constitute possession by the creditor for purposes of perfecting a security right in the goods. Another example of a situation in which dispossession may be possible is an arrangement known as "field warehousing", in which an agent of the creditor resides on the debtor's premises to monitor the collateral. However, in both of those situations, in order to be deemed to have possession under applicable law, the creditor must exercise a substantial degree of control over the outflow of the collateral. Such control either may be impractical or may add a significant layer of cost to the financing arrangement, thereby making the financing more expensive for the debtor or inhibiting it.

43. The requirement that the debtor be dispossessed is in some jurisdictions applied to all property of the debtor, tangible and intangible. As a result, debtors in those jurisdictions are not able to grant security rights in their intangible personal property, such as intellectual property rights, since it is impossible to convey possession of intangible property.

44. The availability of non-possessory security rights in property generally is regarded as being particularly critical to the growth of cross-border secured financing.[18] The creation of an appropriate public notice filing system may serve the role of publicizing

the existence of a security right. In that way, third parties relying on the debtor's possession of the property as an indication of the absence of any security right in the property are not misled.

4. Proceeds of collateral

45. A number of important issues for consideration arise in connection with sales or other dispositions of collateral by the debtor. The first issue is the extent to which a security right in collateral should automatically extend to proceeds arising from the sale or other disposition of such collateral. One has to wonder, for example, whether a security right in inventory should automatically extend to the receivables or cash proceeds arising from the sale of the inventory in the ordinary course of the debtor's business. It has been observed that this issue is of critical importance in those jurisdictions in which financing secured by inventory is widespread. Since inventory is continually sold in the ordinary course of a debtor's business to purchasers who take title to the inventory free of any security right, the value of an inventory creditor's collateral would be depleted each time the debtor sold inventory. For that reason, in some legal systems the security right of an inventory creditor extends to the debtor's right to receive payment from its customers for the inventory sold. In other legal systems, however, a security right in inventory does not automatically extend to proceeds of the inventory.

46. There are a number of ways in which the issue is approached in the various legal systems. One approach is to permit creditors to obtain a security right in proceeds that is not only enforceable against the debtor but also against the debtor's other creditors and remains effective in insolvency proceedings. Jurisdictions that have adopted such an approach focus on whether the proceeds can be traced back to the original collateral.

47. A second issue is the extent to which the sale or other disposition of collateral extinguishes a creditor's security right in that collateral. It may well be appropriate that the sale or other disposition of collateral (such as sales of inventory) in the ordinary course of business, or with the consent of the creditor, should extinguish the creditor's security right in the collateral. For a harmonized provision, the extent to which that solution is not appropriate for sales out of the ordinary course of business, unless the creditor consents to the sale, should be considered.

5. Retention of title arrangements

48. In many countries, it is customary for sellers of goods to retain title to the goods until the purchase price is paid in full. This is generally accomplished by a provision in the sales contract. In those situations, a creditor's security right in property subject to such retention of title may be null, inasmuch as a debtor cannot grant a security right in property that it does not own. Creditors wishing to extend loans against a debtor's inventory or equipment in those countries must engage in costly information gathering to determine if such assets are subject to retention of title agreements and, if so, the creditors must obtain releases from the sellers in order to obtain a security right in those assets.

49. Some countries have enacted laws recharacterizing title retention arrangements as security rights and requiring holders of such rights to comply with publicity requirements pertaining to security rights. It has been suggested that that approach has advantages. To the extent public notice of the title retention arrangement is required,[19] a subsequent creditor will not be required to engage in the information gathering referred to above. Secondly, if title retention arrangements are subject to the same rules of compliance as other forms of secured financing, the costs of establishing a title retention arrangement will be more closely equivalent to the costs of establishing such other forms of secured financing, thereby fostering competition among secured creditors based on cost of credit alone. It is therefore suggested that the possible future security interest regime should adopt a position regarding retention of title.

6. Non-discrimination against non-domestic creditors

50. Another issue for consideration is the treatment of domestic and non-domestic creditors. It has been observed that some jurisdictions already have laws that promote secured financing, but do not extend the benefits of those laws to non-domestic creditors. As a result, many potential creditors are precluded from obtaining the benefits of such laws, a circumstance depriving commercial enterprises located in those jurisdictions of exposure to a broad range of potential

creditors. Extending the benefit of financing laws in a given jurisdiction to non-domestic and domestic creditors alike, on a non-discriminatory basis, would help to promote greater access to secured financing in that jurisdiction. Such provisions may further reduce the costs of financing in that jurisdiction by encouraging competition not only among creditors located in that particular jurisdiction, but also among creditors located outside it. It should be noted, however, that the regulatory regime for banking activities in many jurisdictions subjects financial institutions to a specific regulatory oversight and may include requirements such as prior licensing with the appropriate authorities in order for foreign financing institutions to operate in that jurisdiction. Non-discriminatory provisions of the type mentioned above would not be meant to interfere with the domestic regulatory regime for banking activities in the jurisdiction implementing them.

B. Issues pertaining to priority of security rights

1. The priority of the security right; the establishment of a notice filing system

51. In order for a creditor to achieve the requisite level of certainty to induce it to engage in secured financing, it is not sufficient that the creditor be able merely to obtain a security right in the collateral that is enforceable against the debtor as a matter of contract. The creditor needs to be able to assess, with a high degree of certainty, the extent to which its security right has priority over other creditors and remains effective in insolvency proceedings.

52. In order to facilitate that assessment by the creditor, some countries have introduced a notice filing system, under which public notice of security rights in various forms of collateral must be given and priority is based, with some exceptions, on the earliest filing.[20] It has been suggested that an accessible, reliable and efficient filing system, both with respect to searching the system for competing security rights and registering security rights, may be an effective means of establishing priorities and notifying creditors of the presence of conflicting security rights. Such a system may also be conducive to promoting the availability of low-cost secured financing. From a creditor's perspective, a filing or registration system avoids the risk of relying on representations of the debtor as to the absence of conflicting security rights and may reduce the need to obtain assurances from third parties. However, in other legal systems no such notice filing system exists. In such systems, financiers rely on representations by borrowers and on information available to financing institutions.

53. In view of the above, when examining the matters that might be addressed in a legislative guide on secured financing, the Commission may wish to consider the advantages and disadvantages of the establishment of a public notice filing system with respect to non-possessory security rights. While in the past there were logistical impediments to establishing a notice filing system, recent technological advances have considerably facilitated the establishment of such a system.

54. The Commission may further wish to consider a number of particular implications related to the establishment of a system for publicizing the existence of security rights, such as privacy issues and rules for determining the priority of conflicting security rights. Priority may be based on the time when the security right is created, as is the case in some jurisdictions, or on the time when the security right is publicized.

2. Purchase-money security rights

55. Some jurisdictions have enacted laws encouraging various forms of "purchase-money financing". This term refers to a financing arrangement under which a seller of goods or other property extends credit to its purchaser to enable the purchaser to acquire the property or a creditor lends funds to the purchaser to enable the purchaser to acquire the property. In both cases, the seller or creditor will receive a security right in the property to secure the extension of credit. Such laws generally provide that, under some circumstances, a purchase-money security right in property can have priority over other security rights in the same property, thereby enabling a creditor to make purchase-money loans without having to negotiate a subordination agreement with the debtor's other secured creditors, who may have an otherwise prior security right in the same property, each time the purchase-money creditor makes a loan. In order for purchase-money creditors to obtain that security right, such creditors are often required to give notice to the debtor's other secured creditors, so that those other secured creditors do not

make loans predicated on the property subject to purchase-money security rights.

56. It has been suggested that purchase-money financing provides an effective and useful form of financing for debtors and one that also encourages competition among creditors. One common type of purchase-money financing is known as "floor-planning". Under a floor-planning facility, a creditor makes loans to finance the acquisition of a debtor's stock of inventory. Such a facility is often provided to debtors that are dealers in items such as automobiles, trucks or other vehicles, computers and large consumer appliances. The creditors in those arrangements are often finance entities affiliated with the manufacturers. Another common type of purchase-money financing is known as "purchase order financing". Under that type of facility, the creditor typically provides funds to finance the fulfilment by the debtor of specific purchase orders, which often includes the purchase by the debtor of the inventory required to complete the orders. The loan will be secured by the purchase orders, the purchased inventory and the resulting receivables. Among its other benefits to debtors, purchase-money financing serves a pro-competitive purpose in that it enables a debtor to choose different creditors to finance different components of the debtor's business in the most efficient and cost-effective way.

3. Other preferential claims

57. Another set of issues to be considered in connection with the establishment of a legislative guide on secured financing relates to the treatment of preferential claims. In many countries, there are various categories of preferred creditors whose security rights could rank ahead of those of a secured creditor. Such preferential claims often relate to unpaid taxes and wage-related claims and may cause uncertainty for secured creditors to the extent they are unpredictable and could rank ahead of a creditor's security rights even if the claims arise after the time that the creditor obtains and publicizes its security right.

58. To avoid discouraging the availability of secured financing, it may be considered that preferential claims should only be provided to the extent that there is no other effective means of satisfying the underlying objective of the preferential claims. To the extent that preferential claims are created, the laws establishing them should be sufficiently clear that the secured creditor is able to calculate the potential amount of the preferential claims and to reserve for such amount.

59. A legislative guide on secured financing could approach the issue of preferential claims in a number of different ways. One way would be to adopt the approach taken in the UNCITRAL draft convention on assignment of receivables, which looks to the law of a particular jurisdiction to determine the nature and extent of preferential claims. Another approach would be to establish a system ensuring publicity for preferential claims.

C. Issues pertaining to enforcement of security rights

60. The value of a security right is significantly impaired if the creditor is unable to enforce it in a reasonably predictable and timely manner and without having to incur excessive costs. When assessing the risks of extending secured loans to debtors in a given country, creditors typically review carefully the reliability and efficiency of the existing procedures for enforcing their security rights. The laws of some countries provide for non-judicial procedures for enforcing security rights in certain types of collateral, while in many countries resort to a judicial proceeding is required. In the latter case, the perceived risk of extending credit in any given country will be dependent on the efficiency of the national judicial system and the availability of effective forms of judicial enforcement of security rights.

61. Certain issues for consideration in connection with establishing a legislative guide on secured financing relate to the creditor's ability to take possession of its collateral upon the occurrence of a default by the debtor. In that respect one has to wonder, for example, under what circumstances, if any, a creditor should be permitted to take possession of its collateral without resort to judicial process (an issue sometimes referred to as "self-help"). One also has to wonder whether the creditor should be permitted to do so as long as there is no breach of the peace; whether the creditor, under appropriate safeguards, should be permitted to use the collateral, or the debtor's premises, under certain circumstances (such as to turn inventory consisting of work in process into finished goods); what types of disposition proceedings should be permitted; whether a public sale should be required;

or whether the creditor should be permitted to conduct a non-judicial private sale or other disposition of the collateral. There must be a balance between a creditor's need to obtain control of its collateral quickly before it is depleted or loses market value and the establishment of safeguards to insure that the rights of the debtor and other creditors of the debtor are adequately protected.[21]

V. Security over specific assets: investment securities

62. The development of a legislative guide on secured transactions in general does not necessarily render superfluous the drafting of other, more asset-specific, uniform rules, since the solutions on secured transactions in general may not be suited to solving all the specific problems linked to taking security interests over specific assets. Thus, one may conclude that general rules should rather be regarded as default rules, applicable where asset-specific rules do not provide any solution. At its thirty-third session, the Commission identified securities as one of the assets that may require asset-specific solutions.[22]

63. "Securities" or "investment securities" is an economic rather than a legal category, understood differently in various countries. For the purposes of the present paper, it will suffice to indicate some major categories of security by way of example: bonds (a marketable document incorporating or evidencing a monetary debt of the issuer); shares (a marketable document incorporating or evidencing a right of membership in a corporation); depository receipts (a marketable document representing or evidencing either shares or bonds issued in another country); participating certificates (a marketable document incorporating or evidencing the right to share in the profits and the proceeds of liquidation of a corporation); warrants (a marketable document incorporating or evidencing a right of option for bonds, shares or monetary amounts); investment certificates (a marketable document incorporating or evidencing participation in an investment fund); all other marketable documents that are comparable to the preceding categories of security; equity rights in privately held companies; and loan participations.

64. The common denominator of the aforementioned categories is their marketable character. However, as a result of recent developments referred to below, the documentary character of the aforementioned categories of security has been weakened, if it has not, as in some cases, disappeared entirely. Where this has happened, since the document incorporating or evidencing the right has disappeared, the "naked" right itself has become the object of the securities. The emphasis, therefore, has shifted from the marketable document to the marketability of the right.

A. Recent economic and technical developments

65. The difficulties now besetting the legal regime of securities and also the creation of security rights in them are due primarily to economic and technical developments that have occurred in recent times.

66. One can distinguish primary and secondary causes. Among the most important primary causes are the tremendous increase of the amount of capital that is raised in the market by the issue of investment securities; the dramatic increase of the number of direct and indirect market participants, as a consequence of the general expansion of wealth, of policies directed at a "capitalism for all" and of facilitated market access; the internationalization and globalization of the securities markets generally, caused by the desire to seek the most profitable national markets and to spread risks, which has enabled market participants to hold, trade and pledge securities issued in different countries and to switch investments from one country to another.

67. Among the related secondary causes, the first is the increase in the quantity of certificates of investment securities that are traded and the increase in costs for storing, guarding, insuring, accounting and moving the certificates. Attempts have been made to solve this "paperwork crisis" in order to save costs and to increase marketability by speeding up the settlement of transactions on securities exchanges. First steps, dating back to the 1920s, consisted of developing systems of indirect holding, where the certificates for investment securities were held by the investor's bank.

68. The other secondary cause is a consequence of the internationalization and globalization of the securities markets generally, because of which systems of indirect holding are even more necessary when the

issuer is domiciled in a country other than that of the investor, since physical transfer of such certificates to the investor's home country would be risky and expensive. Moreover, such transfers would be particularly impractical where a strong market existed only in the issuer's home country, except (which is less frequent) when the foreign securities were formally admitted by and quoted also on an exchange in the investor's country. An alternative, developed especially in the United States, has been the issuance of domestic depository receipts in that country as American depository receipts. They incorporate or evidence an obligation of the issuer to deliver shares of the foreign company for which the depository receipts were issued; this makes possible an indirect domestic trading of the represented shares.

69. Any such system of indirect holding of securities certificates can help to facilitate only one, though an important, element of the paperwork crisis, that is, the burden of moving certificates. A real cure can only be expected from measures aiming at a decisive reduction of securities certificates and this must be, and has been, achieved on the legal level (see paras. 70-74). Thorough reforms in that respect have been and will be greatly assisted by very recent technological developments. In particular, the computerization of the holding and transfer of securities can facilitate or even replace the issue and movement of securities certificates.

B. Legal repercussions of recent developments

70. In order to appreciate the repercussions of recent economic and technological developments on the legal regime of security and other proprietary rights in investment securities, it is first necessary to set out briefly the legal role of certificates (see paras. 71-74). Thereafter the consequences of restrictions upon the role of certificates will be described (see paras. 75-91) and finally the implications of abolishing certificates altogether (see paras. 92-110).

1. Certificates as documents of evidence or of title

71. Since it is the specific feature of securities to be marketable, domestic laws as well as any international regulation must pay special attention to facilitating their marketability. Until about 40 years ago, marketability of securities was widely achieved by the issue of certificates embodying or at least evidencing the proprietary rights connected with securities. In general terms, those traditional rules differentiate between bearer securities and registered securities.

72. The highest degree of negotiability is attributed in most countries to bearer certificates of securities, such as bearer bonds or bearer shares, and to registered securities that are endorsed in blank. The right embodied in the instrument is created by its issuance; its transfer takes place by handing over the certificate to the transferee; the existence of the right depends on the existence of the certificate. Depending on the differing national regulations, bearer certificates may be treated like cash. Since the certificate as the document of title is the only and exclusive evidence, the certificate must be produced if its holder intends to exercise any of the rights embodied in the instrument, such as collecting dividends or interest or voting as a shareholder.

73. By contrast, no negotiability attaches to certificates of investment securities that merely serve as evidence of an entitlement. In those cases, the right is not created by the issue of the certificate but by acts occurring outside the document, such as registration of a shareholder in the company's register or of the owner of bonds in the issuer's books. Transfers require deregistration of the previous and registration of the new owner and those entries will ordinarily only be made against presentation of the certificate and its amendment or the issuance of a new certificate. The evidentiary value of a certificate for registered securities is rebuttable since, in principle, the register prevails over the certificate.

74. The relative importance of bearer and registered certificates of investment securities differs from country to country. Investors often prefer bearer certificates as a visible indication of their investment assets; in some countries tax authorities have insisted on registered securities in order to fight tax evasion and varying traditions have made their influences felt.

2. Restricting the role of certificates

75. In order to overcome the paperwork crisis (see above para. 67), the original role of certificates has been increasingly restricted. As a first step, this has been achieved by developing new techniques of

deposit and transfer of securities, which in fact limit the relevance of certificates, yet without abolishing them. The two most important techniques that were developed in many countries are the immobilization of certificates of securities, on the one hand, and the issue of (permanent) global certificates, on the other (their legal effects are summarized below in paras. 84-91). The first step that was often taken was not sufficient to reduce the number of certificates issued, but it achieved a practical result by immobilizing the existing multitude of certificates and replacing them by another medium. This was and is achieved either on a voluntary basis by persuading investors (by offering them favourable rates) or on a compulsory basis by obliging investors to entrust their certificates to banks or brokers for delivery into collective deposits held by a specialized institution acting exclusively as central depository. Such central (or decentralized) collective depositories have been instituted for instance in Argentina, Brazil, Canada, France, Germany, Italy, Japan, Mexico, the Netherlands, Singapore and the United States. Comprehensive special legislation was enacted for instance in Italy (1986), Japan (1984) and the Netherlands (1977).

76. This basic two-tier system—bank or broker in the lower tier, central depository in the upper tier—is often increased by adding one or more tiers. For instance, the central depositories may not in fact keep all certificates but may delegate that task to specialized agents. In practice, this occurs regularly where securities of foreign issuers are involved (as indicated before; see para. 68). The certificates for such securities are normally kept in their countries of issue, on the basis of differing arrangements between the central depository in the investor's country with (central or other) depositories in the various countries of issue. Alternatively, foreign securities may be deposited with specialized international depositories.

77. Whatever the number of tiers involved, the basic legal effects of all collective deposits are essentially the same. They may be summarized as follows: the specific certificates deposited by an investor and integrated into the collective deposit are no longer allocated to its depositor. If and in so far as redelivery of specific certificates is admitted at all, each depositor is merely entitled to request redelivery of the same number (in the case of shares) or the same amount (in the case of bonds) of the kind of securities certificates originally deposited by it. Correspondingly, in the case of any other disposition, for example, a sale or pledge, the same number or amount of the deposited kind of securities is disposed of.

78. The administration, including the necessary bookkeeping, takes place on at least two levels. The types and amounts of securities deposited by the individual investors are entered in the books of the bank, broker or other agent whose customer the investor is. Those intermediaries, in their turn, are members of a central depository and deliver to it all the securities certificates received from their customers. The types and numbers of certificates delivered collectively by each of the intermediaries are entered under its name in the books of the collective depository. Only the intermediaries, therefore, can dispose, on the instructions of their customers, of the securities entered in the intermediary's name in the books of the central depository. This applies, for instance, to sales or pledges ordered by the customers.

79. As far as the exercise of the monetary rights embodied in the securities certificates is concerned, for instance, the collection of dividends or interest, a distinction has to be made as to whether bearer or registered certificates are involved. In the former case, the intermediaries communicate the collective entitlement of all their customer-depositors to the issuer, receive the global payment and distribute it to their individual customer-investors according to their respective entitlements. In the case of registered certificates, these may be registered individually for each investor with the issuer; alternatively, a collective registration either of each intermediary or of some neutral third institution may have been agreed.

80. The exercise of voting rights is more individualized since each shareholder who elects not to attend a members' meeting will be asked to record its vote individually in writing.

81. What is relevant in the present context is that in none of these cases of exercise of the rights inherent in securities or of dispositions of them do certificates need to be moved or presented. The exercise of rights embodied in securities is made on the basis of book entries at the two or more levels at which books are being kept. The same is true for dispositions of the securities. The immobilization of certificates thus means that the presentation of the certificates and their transfer are replaced by corresponding book entries.

And yet, in the final analysis, those book entries are backed up by corresponding quantities of certificates.

82. Technically, a great step forward can be made by omitting to issue any individual certificates for securities. They are replaced by issuing one permanent global certificate that embodies or evidences the whole issue, that is, the total number of shares "issued" or the total amount of a bond issue. If that step is taken (which may require some legal basis, such as the right of a corporation not to issue individual shares certificates), the very considerable expenses for printing, storing, guarding, moving and insuring individual certificates are saved.

83. The implications of a securities system based on global certificates do not differ essentially from those of a system of immobilized certificates. This explains also why the two systems often exist side by side. Somewhat simplified, one might say that the issue of a global certificate triggers the same consequences as the immobilization of individual certificates, except that those consequences arise right from the beginning, that is, upon issuance of the global certificate, and not only after deposit of the individual certificates. Thus, in the basic two-tier hierarchy, the bankers or brokers share directly and proportionately in the rights embodied in or evidenced by the global share and the customers share indirectly in those rights via their intermediaries.

3. Legal consequences of restricting the role of certificates

84. The major development that has been noted is that the investor has lost its direct connection with the issuer of its securities. The investor no longer directly possesses bearer securities that would enable the investor to assert the rights embodied in those certificates against the issuer. Frequently, the same is true for registered securities provided that, as frequently happens, the individual share- or bondholder is no longer registered by the issuer, but only by its banker or broker.

85. The intervention of those and other intermediaries creates new risks, especially in the case of insolvency of any member in the chain of intermediaries. Most countries seem to counter that risk by asserting that the investor, instead of the former exclusive ownership in the certificated securities, has obtained a co-ownership share in the collective fund of certificates or the global certificate deposited with the central depository. Thus, the immobilized securities certificates or the global certificate still serve as a basis from which a proprietary entitlement through all tiers down to the customer investor is derived. However, in those civil law countries where transfer of ownership also requires transfer of possession, difficulties are seen in effectuating those transfers through the chain of intermediaries.

86. Moreover, doubts are being expressed as to whether in fact the rules on transfer of ownership that are designed for transfer of tangible movables are applicable at all, since the investor now has an intangible right and possession of an intangible is difficult to perceive. More and more, therefore, legislative clarification is demanded in order to dispel any doubts on the legal status and protection of all the participants of the modern tiered systems of holding securities.

87. Closely connected with the preceding issue of protecting the investor as holder of securities is its protection as buyer or seller. How is its position in transfers of securities legally assured? In particular, how can the protection of rights predicated upon the transfer of possession be assured in a system where intangible rights are being transferred that are incapable of possession?

88. A third aspect concerns the protection of the investor's secured creditors. It must be emphasized that the taking of security in investment securities plays an important role in practice since securities are an ideal type of collateral: they are easily available, they can easily be created and they can easily be sold and enforced.

89. Three questions arise. Firstly, is it possible to obtain quickly reliable security in the debtor's securities? Secondly, is the secured creditor sufficiently protected against competing rights of third parties? And, finally, are the rules on enforcement of the security interest in keeping with the special features of a highly marketable collateral?

90. In view of the globalization of the securities markets and also of individual investor's holdings of securities, the de-emphasis of certificates raises an important problem as to the applicable law. Individual certificates of securities that embody the investor's rights, such as bearer certificates, must be regarded as tangibles and therefore are governed by the law of the

State where they are located (*lex rei sitae*). For registered securities, especially registered shares, it depends upon the issuer's law whether and to what degree that qualification applies.

91. In view of the modern restriction of the role of certificates, serious doubts have been raised as to the adequacy of the traditional generally recognized rule of the *lex rei sitae*.

C. Abolition of certificates

92. In the legal systems where the role of certificates for securities was merely restricted, either the certificates were preserved and immobilized or only one permanent global certificate was issued. Technically it is only a small step from the one global certificate to omitting the issuance of any certificate. However, legally that small step has far-reaching implications.

93. The decision to omit issue of any certificate may be taken voluntarily by individual issuers, provided they are authorized to take such a decision. Alternatively, the abolition of certificates may be imposed by legislation for all investment securities. The first alternative has been chosen, inter alia, by Belgium (1995), India (1996), Spain (1988/1992) and the United States (1977). For public debts a system of dematerialization was introduced earlier, the central registry being kept usually by an institution supervised by the ministry of finance. Dematerialization has been ordered, inter alia, in Denmark (1980/1982), France (1982/1983), Italy (1998), Norway (1985), Singapore (1993) and Sweden (1989).

94. Whether the voluntary or the forced approach is chosen, it is necessary to regulate the legal regime of dematerialized investment securities and that has been done in all of the aforementioned countries. In the context of the present report it is not necessary to present a comparative survey of that legislation. It suffices to mention the most important issues addressed by the various laws and decrees.

95. Institutionally, the two-tier system, as described in outline above (paras. 75 and 76), for systems restricting the role of certificates has been adopted. In the present context, of course, the intermediaries of the lower rank, banks and brokers, that is, no longer act as collective depositories, nor does the central institution in the upper level act as central depository. Rather, the role of all those institutions is restricted to a book-keeping function—that of the bankers/brokers with respect to their customer investors and that of the central institution with respect to the banks and brokers that are their members.

96. The function of book entries is the same as in the systems restricting the role of certificates. The holdings of securities, their transfer and also their pledging depend upon corresponding entries in all tiers of the system, but primarily in the lower tier.

97. With the complete abolition of any certification of securities, the basis for qualifying both the intermediary's and the investor's entitlements as co-ownership of either the fungible certificates in the collective deposit or in the permanent global certificate deposited has fallen away. This is especially true for legal systems that limit ownership to tangibles that are capable of possession. Much speaks for the assumption that the rights that are evidenced or constituted by book entries are intangibles and therefore incapable of possession.

98. According to general rules that in essence seem to be followed everywhere, proprietary dispositions over intangibles, that is, especially transfer of ownership and creation of security rights, are subject to special rules on assignment that deviate from corresponding rules on proprietary dispositions over tangible movables. The differences affect the mode of transfer since physical delivery is obviously impossible. Moreover, such rules do not, in general, provide a clear-cut protection of a good faith transferee against defects affecting the transferor's entitlement to, or power of disposition over, the intangible.

99. Even more important is the different degree of protection that intangibles enjoy in the insolvency of the intermediate holder of the right. The issue is the investor's protection in the insolvencies of the "new" intermediate holders, that is, the various members of the two (or more) tiers of intermediate and central collective depositories. In economic terms, such risk is very low with respect to the various national central depositories, in so far as their functions are usually strictly limited to the keeping of central records and, under the "certificate restricting systems" (see paras. 75-77), to the deposit of immobilized or global certificates. Thus there is almost no credit exposure. The same probably applies to specialized depository

companies. The matter is quite different with the members of the lower tier, that is, banks, brokers and similar institutions pursuing broad business purposes; the intermediary function of keeping books for entries concerning customer entitlements in collective deposits is only one (and possibly of minor importance) among many others. The entitlement to intangibles is traditionally, as a rule, regarded as a personal right only and one which therefore does not entitle its holder to proprietary protection in any intermediary's insolvency. That result is a decisive setback vis-à-vis the full protection that the investor as co-owner enjoys under the rules governing collective deposits based upon immobilized certificates or a permanent global certificate. In order to avoid such diminution of the investor's protection, the special statutes that govern completely dematerialized investment securities usually provide that the investor's position is that of a co-owner of the securities booked in its name. The guarantee of that proprietary status is an essential element of any modern national as well as international regulation of the holding, transfer and pledging of uncertificated securities.

100. The "reification" of the investor's entitlements to investment securities is also an important element for regulating the creation, status, protection and enforcement of security rights in those securities. In that respect, there is an important difference between the common law and the civil law systems: while the latter allow a pledging of intangibles, the common law does not, on the ground that the essential prerequisite of delivery of the pledged movables to the pledgee cannot be effected in the case of intangibles. The civil law countries substitute a notification of the debtor for delivery. As a substitute for the inadmissible pledge, the common law system permits the (security) assignment of intangibles. Such a form of strong security is also allowed by some civil law countries; others regard it as a circumvention of the statutory pledge rules and therefore do not allow assignment for security.

101. The dilemma arising from such basic (and additional minor) divergences can be remedied by the reification of the intangible entitlement of investors in securities. Then the ordinary rules on pledges of tangible movables become applicable.

102. An adaptation to the general system of book entries for investment securities is still necessary. That, however, can be achieved by providing either for special pledge accounts or for pledge notations on the pledgor's existing account.

103. While the regime for pledges is relatively coherent in all countries, certain differences do exist and ought to be adapted to the special requirements of an effective security right in securities. One (probably controversial) point is the desire of lenders against securities to be entitled to repledge the pledged securities. Other points relate to the relaxation of certain cumbersome and expensive formalities for the valid creation of a pledge and especially to an easy and fast regime for enforcement by the pledgee, which, in view of the existing well-functioning securities exchanges, should clearly be more liberal than for pledges of other assets.

104. In that context, two further issues arise. Firstly, one has to wonder whether it is possible to merge any regulation of a modernized pledge with alternative legal or functional equivalents. Legal alternatives are security transfers of ownership; functional alternatives include sales-and-repurchase agreements ("repos"), which are used very frequently, probably because of lack of adequate modern forms of pledging. However, this appears to be an issue that cannot and need not be solved at the present stage, but can be left to subsequent deliberations.

105. Another problem is whether any regulation of a specific application of security interests does not prejudice potentially broader plans to develop harmonized general rules for modern security interests, covering all types of assets. However, it would seem that the peculiarities of creating, protecting and enforcing security interests in investment securities are so strong that deviations from a general regime can be justified by the special features of the collateral involved.

106. In view of the globalization of the securities markets in general and consequently also of the holdings of both major professional and small private investors, a final but difficult issue is which law applies to the proprietary aspects of holding, transferring and pledging securities.

107. Under the traditional system of certificated and individually held securities, the general rule was that the property aspects of securities were governed by the issuer's law, unless that law referred—as it usually did for bearer and equivalent securities—to the *lex situs* of

the certificates. However, the new economic and legal developments that have been briefly described above (paras. 65-69 and 71-74) give rise to doubts as to whether those two basic conflict rules are still adequate in the present situation.

108. In view of the generally restricted role of certificates (see paras. 75-83) and their eventual abolition in certain countries, the strongest doubts affect the subsidiary conflict rule that refers to the *lex situs* of the certificates. Where the vast majority or all certificates of one issue are immobilized and deposited at one place or where the only global certificate happens to be located, should the law of that place—as *lex situs*—really govern the proprietary rights of all owners, possibly residing in all corners of the world? Consider a purchase by a Japanese resident of shares in a German company that are centrally deposited in Germany: should the question of whether and when the buyer acquires title be governed by German law even though the steps for transferring title are taken in Japan by corresponding book entries effected by the seller's and the buyer's banks in Japan? Does it make a difference whether the seller is a Japanese bank in Japan or a German bank in Germany? In an exchange transaction, the buyer normally will not know the identity or residence of its seller. The same problems arise if a security interest is to be created, except that the parties then know their identities.

109. Of course, in the case of a total abolition of certificates, the question as to the location of the securities becomes moot.

110. A substitute for the *lex situs* that has been suggested by some authors and adopted by a few legislators is the law governing the book entry. This appears to make sense in many cases where both parties reside in the same country and their identities are known. However, the rule does not seem to work in a border-crossing disposition where book entries in both countries are necessary, since it would be difficult to determine whether one of the two book entries should prevail over the other and, if so, which one.

D. Work in progress on security rights in securities

111. It has been said that the lack of harmonization of laws and regulation regarding collateral hinders the growth of collateralization in many areas, especially Europe and that legal uncertainty is still a major concern of institutions collateralizing transactions around the globe.[23] This is why it is not surprising that various initiatives for legislative improvements of the legal regime for securities are under way. Those efforts are of two types: those aimed at the unification of substantive rules and those relating to the unification of conflict of laws rules.

112. The Commission of the European Communities published a preliminary draft of a directive on the cross-border use of collateral in 2000. However, article 1 makes clear that only "financial collateral" will be covered. The draft covers both "security" and "title transfer". As to substance, the draft deals briefly with creation of security interest; it allows use of the collateral and covers enforcement by the creditor. Enforcement is not to be barred if the collateral provider becomes subject to insolvency proceedings; certain arrangements are also to be immune from insolvency rules affecting the validity of transactions effected in the suspect period. Finally, a conflict of laws rule for book-entry securities is suggested; it would apply, whether or not the law to which reference is made is the law of a member State.

113. Some member States of the Hague Conference on Private International Law requested in early May 2000 that the Hague Conference put on its agenda the conflict of laws relating to securities held through intermediaries. The original proposal had been confined to dealing only with the conflict of laws issues arising in the context of taking securities as collateral. However, it was subsequently pointed out that it would seem undesirable to clarify the conflict of laws principles only with respect to one type of disposition; there was no reason why the proposed convention should not deal with all dispositions of securities held through intermediaries.

114. After discussion, the Hague Conference decided that the proposed new topic should be made part of the agenda for the next diplomatic conference, which is to convene in June 2001. A working group was instituted. It was suggested that the conflicts rule to be drafted should lay down the criterion of the law of the "place of the relevant intermediary".

115. It should be mentioned that the aforementioned draft European Union directive on the cross-border use of collateral also contains a conflict of laws rule for

book-entry securities. The proposed article 11 lays down that priority and enforcement of any title to or interest in book-entry securities is governed by the law of the country in which the relevant account is maintained.

116. As described above (paras. 65-69), in the last 30 years the holding, transfer and pledging of securities have been subject to change in many countries. The laws of the different countries have taken those developments into account only to a limited extent and in widely different manners. Generally speaking, most general private law is quite inadequate to deal with the demands of the modern securities industry. That lack of adequate national rules and rules for cross-border transactions increases costs for all such transactions and impedes economic progress. Data clearly show the high volume of financial values that is involved. And, finally, recent initiatives of the securities industry support the preceding findings and emphasize the need for a more modern law, both at the national and the international level.

117. When deciding whether to embark on work relating to security interests, the first issue to be considered is whether new rules should be considered only for the creation and enforcement of security interests in securities. However, the observations made above (paras. 65-69 and 70-74) suggest that the insufficiencies of legal regimes are not limited to the creation and enforcement of security rights. Rather, the same factors also affect the related legal rules on the holding and transfer of securities.

118. Those issues form one integrated, interdependent whole. Each issue depends on the solution that is followed for the basic regime, that is, the legal form of holding securities by the investors and their intermediaries. And since the legal regime for all those issues is partly uncertain and partly unsatisfactory, it would not be wise to deal with only one of them.

119. Nevertheless, it would be possible to restrict the topic to security rights in securities. Feasibility is demonstrated, for instance, subject to closer analysis of details, by the existence of the draft directive on cross-border collateral of the European Communities.

120. Another issue relating to the delimitation of the work is whether any new proposals should be limited to "pure" book entry systems where all certificates have been completely abolished or whether the regimes for immobilized securities or those based upon a global certificate should also be included. The broader view may be preferred. As has been shown, the decisive legal "break" occurs as soon as certificates are taken out of service and are put to rest, so that book entries and substitutes based upon them must take their place.

121. A different question of delimitation is whether an instrument should deal with both domestic and international situations or whether it should deal only with international ones.

122. The development of a set of rules covering both domestic and cross-border holdings and dispositions does not eliminate the need to deal with possible conflicts of laws. Such conflicts may arise whenever a country that has not adopted the rules to be prepared is affected.

VI. Security over specific assets: intellectual property rights

123. At its thirty-third session, the Commission identified intellectual property rights as a further topic for possible asset-specific future work in the area of security interests.[24]

124. For the purposes of the present discussion, the term "intellectual property rights" is understood as including copyright and related rights; trademarks, trade names and other distinguishing business signs; geographical indications; industrial designs; patents; layout designs (topographies) of integrated circuits; and trade secrets and, more generally, undisclosed information.

125. The increasing value of such rights and the fact that they offer an essential component of the value of companies has led them to be considered as assets suitable to be used as collateral.

126. From a legal perspective, difficulties arise in connection with the fact that intellectual property laws usually focus on the transfer of ownership of those rights and do not contain specific rules on the creation of security interests in those rights. Accordingly, the task of adapting the general rules on security interests to intellectual property rights is usually left to case law. As a consequence, many uncertainties exist as to the substantive rules governing the exercise of the

intellectual property right throughout the duration of the security. Such uncertainties relate, for example, to the conclusion of licence agreements; the treatment of infringements; the extension of the security over benefits and revenues resulting from the right (like royalties); the consequences of the right being declared invalid or of the commencement of insolvency proceedings in respect of the debtor owning the intellectual property right; the scope of party autonomy; and the formalities required for perfection of the security interest.

127. A further area of uncertainty exists in respect of trademarks. Some laws provide that trademarks cannot be transferred separately from the goodwill of the business or product they represent, the assignment being otherwise invalid. Since enforcement of the security in the trademark would require assignment of both the trademark and the business concern, the effectiveness of the security interest in the trademark requires the contemporaneous creation of a security over the business concern as a whole.[25]

128. Obstacles seem also to arise in connection with the identification and evaluation of intellectual property rights. On the one hand, such obstacles may arise where no registry is provided for specific types of intellectual property rights. On the other hand, even when a registry is in place, registration may prove impractical and costly for items constantly being revised and replaced by more updated and sophisticated versions.

129. One way to rely on an intellectual property right for the purpose of obtaining financing, while avoiding the uncertainties connected with security interests therein, is to transfer ownership of that right to the creditor. As the holder of title to the right, the creditor is entitled subsequently to license the right back to the debtor, who can continue to exercise and exploit it. A drawback of that approach is that the creditor, as the holder of title, is subject to all filings and other actions required to ensure maintenance of the right, irrespective of the extent to which such creditor is involved in the business of the debtor. Furthermore, the creditor is also obliged to take action against infringements of the intellectual property right. Further difficulties might arise in connection with the need for the licence to provide for devices ensuring that the debtor does not use the intellectual property right in such a way as to diminish the value of the security interest, thus adversely affecting the position of the creditor. Such difficulties and risks might reduce the appeal of the approach to creditors, the more so when they are not willing to become directly involved in the business of the debtor.

130. Some civil law countries allow the creation of security interests in intellectual property rights under the mechanism of a pledge of rights. Under a pledge of right, the creditor is entitled to the proceeds of the sale of such right upon the debtor's default.

131. Other countries allow the use of intellectual property rights as collateral under different legal mechanisms, usually referred to as "fixed" or "floating" charges. The central feature distinguishing a floating charge from a fixed charge is that security is given not on a specific asset, but rather on a fluctuating body of assets that the debtor is entitled to use in the course of business. Those assets, possibly including one or more intellectual property rights, remain under the full control of the debtor throughout the duration of the security and may include, among other things, equipment specifically designed for the production of a patented product or inventory branded with one or more of the debtor's trademarks. Since exploitation is essential to the survival of intellectual property rights as valuable economic assets, that mechanism allows such value to be preserved in spite of the existence of a security interest. In case of enforcement of the security, under a floating charge the creditor is only entitled to receive the amount for which the security was given out of the proceeds of the sale of the assets of the debtor and participates in their distribution together with other creditors, whether secured or unsecured.

132. When a security interest in an intellectual property right is given in the form of a "fixed charge", such right is secured to the exclusive benefit of a specific creditor. Accordingly, such creditor is entitled to receive preference vis-à-vis any other creditor in respect of the proceeds arising from its sale. Under a fixed charge, however, title to the secured asset is transferred to the creditor, who is vested with all of the incidents of legal ownership. That feature may create inconveniences similar to those arising under the solution of straightforward assignment coupled with licence back to the debtor whenever the creditor is not willing to oversee the use and the exploitation of the intellectual property right.

133. A further difficulty arises in connection with the so-called "territorial rule" of intellectual property rights, namely, registered trademarks and patents. The expression defines a general and universal rule according to which the exclusive rights arising from registration are geographically limited to the territory of the State in which registration of the trademark or of the patent was granted and are governed by the law of that State.[26]

134. The territorial rule also implies that intellectual property rights are subject to filing and registration with administrative authorities established within the jurisdiction where protection and enforcement are sought. The legal effect of such registrations varies. In some systems the registry is meant as a mere source of information; in others the existence of the intellectual property right (or of any kind of right therein, such as a security interest) is conditional upon registration. That disparity of treatment inevitably results in adding further uncertainties and making it more difficult to rely on intellectual property rights as a means of obtaining financing.

135. Such difficulties are expected to increase in respect of new forms of intellectual property rights that may develop in connection with the expanding use of electronic commerce. So far, the most significant example is that of domain name addresses, whose relationship to traditional trademarks is still unclear.

136. Substantive and procedural uncertainties as to the regime applicable to security interests in intellectual property rights affect the availability of credit linked to those rights. In order to facilitate the use of intellectual property rights as collateral, both owners of intellectual property rights and creditors would require more predictability and legal certainty.

VII. Private international law issues

A. Scope of conflicts of law rules in the context of substantive law unification

137. It is commonly understood that the unification of substantive rules is to be preferred over the unification of conflicts of law rules.[27] This does not mean that conflicts of law issues are irrelevant in the context of substantive law unification. There are cases where, even if broad substantive uniformity were to be achieved, there would remain a need for conflict of laws guidance for various reasons. Firstly, to the extent that the effectiveness of security rights, whether between the parties or only against third parties, depends under national law on public registration of notice of the right or an equivalent act of publicity, secured creditors require choice of law guidance as to the relevant venue (barring establishment of an international registry). Secondly, secured transactions law is not a self-contained body of law. It intersects with a variety of other areas, notably contract, debtor/creditor and judgement enforcement law, consumer protection law and corporate, bankruptcy and insolvency law. An internationally uniform substantive regime for security rights cannot achieve uniformity throughout those neighbouring areas. There will remain a need for choice of law guidance to varying degrees on the law applicable to questions that arise at the intersection of secured transactions and the neighbouring areas. Thirdly, to the extent a uniform substantive secured transaction is set out in an international convention there will inevitably be gaps within the text.

B. Tangibles

138. As in the other parts of the present paper, the generic term "security right" is used here to refer to property rights created by a device that is secured both in form and function (e.g. pledge, hypothec or charge), as well as security rights created through the use of other arrangements (e.g. sale, lease, transfer or retention of title or trust) to secure sales or loan credit. The present section makes a distinction between purely contractual issues arising between the immediate parties to a transaction creating or evidencing property rights, on the one hand, and the property aspects, on the other, with the former generally subject to the principle of party autonomy.[28]

139. It is widely agreed that, as a general rule, the proprietary aspects of contracts for the transfer or creation of property rights in tangible movables, including security rights, are governed by the law of the place where the asset is located. This includes the formalities for a valid security right, the essential validity of the right, the time of creation of the right, the effectiveness of the right against third parties and its priority ranking.

140. An alternative approach is based on a distinction between disputes involving the immediate parties to a transaction and disputes involving third parties, rather than on a distinction between contractual and property effects of the transaction. In that view, both the contractual and property effects of the transaction would be capable of regulation by a freely chosen law when the dispute involves only the immediate parties.[29] That approach has the advantage of enhancing party autonomy. However, to the extent that the parties contemplate from the outset that an ultimate disposition and sale of the secured assets to a third party may be necessary if the debtor defaults, it may be that property disputes can only with difficulty be confined purely to the immediate contracting parties.

141. Formalities seem to present special problems as regards movables since the contract is typically also the vehicle by which the security right is created yet compliance with certain contract formalities (e.g. writing, a notarized "certain date" or registration of the contract document) may be a precondition for the validity of the security right as a property right under the law of the location of the asset. In theory, the distinction between contractual and property effects means that the contract may still survive as a contract if valid by the law or laws applicable to purely contractual formalities (with the result that the debtor remains under a personal obligation to effect the transfer or creation of the property right contemplated by that contract). On the other hand, if non-compliance with the contract formalities for security agreements imposed by the law of the location of the asset prevents a valid property right from being constituted, no security right will vest in the creditor.

142. However, the distinction between the validity of the contract creating or evidencing the security right and the validity of the security right as a property right is not universally prevalent, with some legal regimes extending the liberal validating rules of private international law applicable to the formal validity of contracts to the formal validity of the security right as a property right. Concerns about reduction of transaction costs and certainty would suggest that the law of the location of the asset exclusively govern the validity of the security right as a property right. Such a solution might obviate the need for interested third parties to investigate the formal requirements of all closely connected laws to determine whether a security right that is clearly invalid because of non-compliance with the formalities under the law of the location of the asset is nonetheless validated under some other law.

1. Choice of law problems resulting from possible relocation of assets

143. Conflict of laws problems are more acute with tangible movables compared to immovables because movables can change their location to a new State after the security right has been created. As long as legal systems restrict security rights in tangibles to the possessory pledge (i.e. where the creditor has the possession of the collateral), mobility does not present acute difficulties. The requirement for delivery of physical possession under a possessory pledge means that most relevant connecting factors are localized at the place where the asset is situated. Even if the pledged asset is removed to another State, the basic substantive law framework for the pledge is remarkably uniform from State to State, so that true conflicts are rare. As long as the creditor retains actual possession at the new place, the security right will generally be recognized.

144. If the asset is not removed to another place, the law of the location of the asset will normally coincide with the law of the forum. The most prominent exception is where insolvency proceedings are pursued against the debtor in a State that takes jurisdiction over the debtor's worldwide assets and the relevant assets are located outside the insolvency forum. Here it is necessary to reconcile the operation of the law of the location of the asset and the law governing the insolvency proceedings. It is widely agreed today that the validity of the security right and its priority status should be governed by the law applicable to it under the relevant national or international choice of law rule. It is then for the insolvency forum to decide, assuming the security right is found to have been validly created under the applicable foreign law, whether it should nonetheless be refused recognition as transactions detrimental to creditors under the substantive law governing insolvency proceedings.

145. The typical problem arising in the case of relocation of the asset given as security occurs when the debtor removes the asset to another State without the consent of the secured creditor and then purports to sell it or borrow money against it or when the asset is attached in that State by one of the debtor's creditors. Which law governs the dispute between the secured

creditor and the subsequent purchaser or creditor? Despite some differences in formulation, the general principle in both common law and civil law countries is that the laws of the two locations of the asset will govern successively. The initial validity of the security right is governed by the original law of the location of the asset, while the law of the subsequent location of the asset determines the legal consequences of events that occur after relocation.

2. Transposition of the security right: problems and possible solutions

146. If the law of the new location of the asset governs the fate of the security right, it is important to know what effect that law will give domestically to foreign imported security rights. In general, the foreign security right will be recognized as valid only if it is capable of being approximated to a domestic security right. The problems of approximation can be acute because of the widely different concepts of security adopted in different legal systems. For example, retention of title arrangements are recognized in many legal systems, so there will usually be no difficulty recognizing a foreign security right created by such an agreement. However, other non-possessory security rights, for example, chattel mortgages, will be recognized only if an analogy can be made to an equivalent domestic security right. Thus, if the domestic law does not recognize security rights that allow the debtor to keep possession of the collateral, the security right may be refused recognition as long as the goods remain in the new law of the location of the asset.

147. Even if an analogous security right can be found for the foreign security right under domestic law, the foreign security right will only be given the legal effects that the corresponding domestic right produces. Non-possessory security rights produce widely varying effects in different countries. Even retention of title agreements, despite their wide use, are not given uniform treatment. In some countries, they are ineffective against third parties. In other countries, they are effective only upon registration or only if the parties can produce certain documentation or otherwise comply with certain formalities. In still other countries, they are effective against creditors and insolvency administrators, but not against bona fide purchasers for value without notice. The divergences among legal systems are even more radical when it comes to other kinds of non-possessory security devices, with some countries continuing not to recognize such rights.

148. One solution to the transposition problem might be a multilateral convention requiring the mutual recognition among contracting States of security rights validly created under the original law of the location of the asset and regulating the substantive effects of such clauses against third parties in the recognizing jurisdiction in a uniform fashion. However, it has proved difficult in practice to implement that solution. States whose domestic laws exclude or restrict the effectiveness of non-possessory rights are unlikely to give greater weight to the third-party effectiveness of foreign rights to the potential prejudice of local buyers and creditors when a domestic security right would not enjoy such protection. Such a convention is therefore apt to be feasible only among States that share at least broadly similar policies on the validity and effects of security rights. In other words, harmonization of internal substantive law seems to be a precondition in practice to uniformity at the conflict of laws level.[30]

149. A potentially more effective solution would be to develop model rules for domestic adoption providing the conversion of a foreign security right into a domestic security right and guaranteeing that right a minimum time period of protection against third parties after relocation to the new law of the location of the asset.[31] States that remain totally opposed to security without debtor dispossession would not be willing to adopt a rule of that kind, but most States now permit some form of security or quasi-security right to exist without dispossession of the debtor, so this is unlikely to be a serious problem.

3. Goods in transit and goods destined for export

150. In the case of goods in transit, the law of the location of the asset rule in principle requires a creditor to comply both with the actual law of the location of the asset at the time of the transaction and the law of the place of destination. However, the location may be either unknown or so clearly transitory as to make compliance practically or economically non-feasible. The latter problem can sometimes be resolved by dealing with the goods through a negotiable document of title to the goods since the applicable law is then the location of the document at the time of its delivery with any necessary endorsement. One has to wonder what happens if the goods are made the subject of an

independent sale or seizure by creditors when they come to rest in the course of transit. Furthermore, one has to wonder what law then applies, the actual law of the location of the asset of the goods or the place of delivery of the document of title.

151. To address those difficulties, the Hague Convention on the Law Applicable to the Transfer of Ownership in International Sales of Movables of 1958 provides that the law of the place of delivery of the goods or of the documents applies in lieu of the actual law of the location of the goods. Application of the law of the place of destination has also been adopted in a number of national legal systems.

4. Application of the lex rei sitae in the case of mobile goods

152. Application of the law of the location of the asset is problematic in the case of security rights in mobile goods, that is, goods that by virtue of their normal function as means of transport or carriage are used in more than one State. In order to avoid the risks inherent in a constant change in the applicable law, a more stable connecting factor is needed. Choice of law theories on mobile goods under national law vary. Some legal systems apply the law of the location of the secured debtor on the theory that that is the place from which the debtor mainly manages the business that relates to the collateral and where third parties, in view of the mobile nature of the collateral, would reasonably expect credit information regarding the debtor to be centred. Other legal systems have attempted to address the problem by establishing public registries for recording both ownership and security rights in cars, transports and similar mobile goods and in some cases for certain machinery used in business.

153. For high-value assets routinely and widely used in international transport (ships and airplanes), most States have established national registries to provide for the public registration of title and security rights where the owners are nationals of that State, with priority generally determined on the basis of the registry. Here, the law of the place of registration offers an obvious alternative to the law of the location of the asset. Domestic registration systems are supported by international instruments, such as the Convention on the International Recognition of Rights in Aircraft of 1948 or the International Convention for the Unification of Certain Rules relating to Maritime Liens and Mortgages of 1926 (see also the International Convention on Preferential Rights and Ship Mortgages, adopted by the International Maritime Organization in Brussels in 1967, and the International Convention on Ship Mortgages adopted on 6 May 1993) and the draft aircraft protocol under the draft Unidroit convention on mobile equipment.

C. Law applicable to security rights in intangibles

1. General remarks

154. Property rights in intangibles, including security rights, represent one of the most intractable areas of choice of law owing to the great diversity among legal systems as regards the appropriate connecting factor to determine the applicable law. Diversity at the choice of law level reflects in part diversity at the substantive level in the basic treatment of intangible assets. In some systems a right to payment or other benefit under a contract is viewed as a sort of property right once its value has been assigned. In other systems, the right retains its contractual character even after it is assigned, on the theory that the assignee in effect merely steps into the shoes of the assignor under the contract.

155. Legal systems that adopt the property view often provide for the application of the law of the State where the "account debtor" (the obligor under the assigned obligation) is located. That solution is consistent with the idea of practical control that underlies, in part, the reference to the law of the location of the asset for tangibles (except that, instead of control over the property, that place has control over the person responsible for payment or performance of the assigned intangible). Legal systems that resist the property approach have tended to settle instead on the law governing the contract between the secured debtor and the account debtor on the theory that the effect of the assignment is merely to substitute the contracting party to whom the obligation is owed.

156. However, application of the law that governs the original contract between the secured debtor and the account debtor may be difficult in the receivables financing context. For instance, in a bulk assignment of receivables owed by debtors located in a number of countries, the assignee would have first to scrutinize

the original contracts to determine the applicable law and would then be forced to conform to the priority rules of all relevant States. The law applicable to priority would vary for different contract receivables, increasing the costs of dispute resolution and insolvency administration. If the assignment included future receivables to be owed by unidentified debtors, the assignee would not even be able to predict what law might apply.

157. In contrast, the debtor/assignor's location leads to a single predictable governing law for the bulk assignment of multiple receivables owed by debtors in different States and for the assignment of future receivables. This is the rule incorporated into the UNCITRAL draft convention on the assignment of receivables in international trade to govern the priority of the secured creditor/assignee's rights in contract receivables against third parties.

2. Intellectual property

158. The rules of private international law governing property rights in intellectual property remain fairly undeveloped. Nonetheless, most analysts seem to agree that issues related to the validity, nature, transfer and third-party effects of intellectual property are governed by the law of each of the States within whose territory protection of the right is claimed. That choice of law rule is thought to follow logically from the fact that the essence of an intellectual property right is the owner's right to prevent others from engaging in certain types of activity. Under the principle of territoriality, which pervades the whole field of intellectual property, protection is granted on a state-by-state basis for activity within that State in accordance with national intellectual property law. The linkage between the essence of the intellectual property right and the territoriality principle that governs choice of law for protection and enforcement leads to the conclusion that the law governing the ownership and transfer of intellectual property rights is the law of the State for which protection is sought.

159. Little analysis has been done on whether the same choice of law principle applies to security rights in intellectual property. It would seem to follow that the law of each protecting country also determines the validity and priority of security rights in intellectual property within the territory of that country.

160. From a commercial financing perspective, however, a territorially divided choice of law approach is inimical to the use of intellectual property rights as collateral in international financing. Firstly, while multilateral conventions have succeeded in harmonizing many aspects of intellectual property law, analysts consider it unlikely that ownership and property rights issues will become uniform or harmonized in the near future. Secondly, national intellectual property laws are often not structured to accommodate secured financing. Although there are many domestic recording systems for patents and certain other rights, and in some countries for copyrights as well, recording systems may not explicitly cover the assignment of rights by way of security, leaving it unclear as to how a security right is to be validly effected against subsequent assignees and competing creditors. Thirdly, even if national laws were brought into line with modern commercial financing concerns, a secured creditor would still have to undertake the burden and expense of satisfying the requirements for taking an effective security right in each State within which protection is sought.

161. One has to wonder to what extent an international convention on secured financing in intellectual property rights could resolve some of those concerns. One possibility might be to establish an international registry for filing notice of security rights in a debtor's intellectual property with worldwide priority effect. A less ambitious alternative to an international registry might be a rule referring the priority of security rights in intellectual property worldwide to a single law, for example, the law of the assignor's location.

3. Investment securities

162. For many years, shares in corporations were held and transferred or pledged by way of a delivery of the share certificate embodying the right or by registration in a record book maintained by the issuer of the investment share. As long as issuers and the holders of rights in the company were in that kind of direct relationship and as long as there was some physical or objective record of the right, the rules of private international law were relatively straightforward and workable. At present, however, securities are more frequently held through tiers of intermediaries and traded cross-border, without the transfer ever being reflected in a certificate or registry at the issuer level. That change in practice has created commensurate

pressures for a more responsive uniform choice of law analysis. The Hague Conference on Private International Law has recently undertaken the preparation of a "fast track" convention designed to create uniformity in the relevant conflicts rules and the European Union's draft directive on collateral also endorses a mix of substantive rules and rules of private international law. National legal systems have also undertaken reform, the recent revisions of articles 8 (Investment securities) and 9 (Secured transactions) of the Uniform Commercial Code of the United States being a prominent example.

4. Law applicable to property rights in cash deposit accounts with financial institutions

163. There is little agreement at the national law level on the appropriate law to govern property rights in cash deposit accounts with financial institutions. Such an agreement is in essence the assignment of a debt owed by the bank to the depositor. Some legal systems treat cash deposit accounts no differently from other categories of payment receivables, referring to the law of the assignor's location consistently with the general rule in the UNCITRAL draft convention on the assignment of receivables in international trade. Other systems apply a law of the location of the asset analysis, treating the debt as situated in the State where the account debtor (i.e. the refinancing institution) is located. Where the bank has branches in more than one country, reference is then made to the particular branch at which the account is maintained or where the monies are payable. Some countries have used that approach with a view to ensuring the application of special priority rules for bank deposit accounts, rules that give first priority to the bank over any competing security interest, essentially require the bank's active consent to any assignment or transfer of an effective right to the account in favour of third parties and prioritize the bank's set-off rights. In contrast, States whose substantive law treats deposit accounts no differently from other categories of payment receivables and does not give special priority rights to banks simply because they also happen to be the account debtor are content to use the general connecting factor for other receivables to deposit accounts, relying on the general rules protecting an account debtor's set-off rights against assignees to preserve the bank's set-off rights against the assigned account.

D. Additional categories where special rules of private international law may be needed

164. Special rules of private international law may be desirable to determine the appropriate law applicable to a number of other classes of property. As the preceding analysis demonstrates, formulation of those special rules of private international law requires analysis not only of existing national law solutions but also study of existing financing practices. Special rules might, for example, be developed for money due under an insurance policy, the proceeds of letters of credit, negotiable documents, assignment of secured obligations and land-related rights (including, e.g., fixtures, crops, timber and minerals to be extracted).

VIII. Conclusion

165. The Commission may wish to take note of the present report and consider whether work should be undertaken with respect to the topics discussed. As to the form that work might take, while a model law might be more desirable from the point of view of completeness and uniformity, to the extent that it would need to reflect certain fundamental guiding principles that would not be common ground to all legal systems, it would represent a significant change from current law in many countries and might, as a result, not meet with sufficient acceptance. At its thirty-third session, the Commission was of the view that a more flexible approach was desirable, along the lines of the preparation of a set of key objectives and core principles for an efficient legal regime governing secured credit along with a legislative guide (containing flexible approaches to the implementation of such objectives and principles and a discussion of alternative approaches possible and of the perceived benefits and detriments of such approaches).[32] If work is to be undertaken towards a set of principles with a legislative guide on security interests, it could also include model legislative provisions where feasible. Possible topics to be addressed in such a guide might include the scope of the assets that can serve as collateral, the perfection of security, the degree of formalities to be complied with, the scope of the debt that may be secured, the limitations, if any, on the creditors entitled to the security right, the effects of bankruptcy on the enforcement of security right and

the certainty and predictability of the creditor's priority over competing interests.

166. While the development of model legislative solutions for secured transactions in general may be suited to address some general aspects of security interests over specific types of assets (such as securities and intellectual property, as discussed in the present paper), there will be a need for special provisions solving specific issues. The Commission may therefore wish to request the Secretariat to undertake further study in close cooperation with international organizations specializing in relevant areas of law, such as Unidroit, the Hague Conference on Private International Law and the World Intellectual Property Organization, with a view to ascertaining whether and to what extent a uniform regime addressing those more specific types of assets would be desirable and feasible and which organizations should be involved in that work. Such a request for further study of the two specific types of asset should not necessarily prevent the commencement of work on a set of principles with a legislative guide for a more general regime on security interests.

Notes

[1] See *Official Records of the General Assembly, Twenty-third Session, Supplement No. 16* (A/7216), paras. 40-48, and ibid., *Twenty-fourth Session, Supplement No. 18* (A/7618), paras. 139-145.

[2] The documents prepared in the context of UNCITRAL work on security interests were: A/CN.9/102, "Security interests in goods", discussed in *Official Records of the General Assembly, Thirtieth Session, Supplement No. 17* (A/30/17), paras. 47-63; A/CN.9/130, A/CN.9/131 and annex, a study on security interests and legal principles governing security interests (prepared by Ulrich Drobnig (Germany)), and A/CN.9/132, on article 9 of the Uniform Commercial Code of the United States of America, discussed in *Official Records of the General Assembly, Thirty-second Session, Supplement No. 17* (A/32/17), para. 37, and the report of the Committee of the Whole II, paras. 9-16; A/CN.9/165, "Security interests: feasibility of uniform rules to be used in the financing of trade", discussed in *Official Records of the General Assembly, Thirty-fourth Session, Supplement No. 17* (A/34/17), paras. 49-54; and A/CN.9/186, "Security interests: issues to be considered in the preparation of uniform rules", discussed in *Official Records of the General Assembly, Thirty-fifth Session, Supplement No. 17* (A/35/17), paras. 23-28.

[3] Formal requirements for the creation of a security interest, action required for the security interests to be effective as against third parties, priority issues, proceeds and remedies in the case of default (see A/CN.9/186).

[4] See *Uniform Commercial Law in the Twenty-first Century, Proceedings of the Congress of the United Nations Commission on International Trade Law, New York, 18-22 May 1992* (United Nations publication, Sales No. E.94.V.14), paras. 268-274.

[5] Ibid., paras. 159 and 271.

[6] *Official Records of the General Assembly, Fifty-fifth Session, Supplement No. 17* (A/55/17), para. 459.

[7] Ibid., para. 460.

[8] Ibid., para. 461.

[9] Ibid., para. 462.

[10] In this section, the term "debtor" is used to refer to the party granting a security right, regardless of whether such party is the actual borrower under the financing arrangement or a guarantor or other party granting a security right to secure a loan or extension of credit to the actual borrower. In order to allow for the greatest use of assets as collateral in an effort to promote secured financing, it is important not only that borrowers be able to grant security rights in their assets, but also that third parties be able to grant security rights in their assets to support loans made to others.

[11] This section does not include a detailed discussion on obtaining security rights in receivables, inasmuch as this is already the subject of the UNCITRAL draft convention on assignment of receivables; for the latest version of this draft, see the report of the Working Group on International Contract Practices on the work of its twenty-third session (A/CN.9/486, annex).

[12] See below the section entitled "Security over specific assets: investment securities" (paras. 62-122), for additional discussion pertaining to security rights in investment securities.

[13] See below the section entitled "Security over specific assets: intellectual property rights" (paras. 123-136), for additional discussion pertaining to security rights in intellectual property rights.

[14] This view has been adopted in the EBRD model law, where article 5, paragraph 2, provides for a broad range of potential collateral types. Specifically, article 5, paragraph 2, provides that "charged property may comprise anything capable of being owned, in the public sector or in the private sector, whether rights or movable or immovable things".

[15] See article 9 of the UNCITRAL draft convention on assignment of receivables.

[16] See article 4, paragraph 3, of the EBRD model law, which provides for securing future advances as long as the maximum amount of the secured debt is shown on the registration statement. Article 5 also provides for securing after-acquired property.

[17] See "Law and Policy Reform at the Asian Development Bank", vol. II, 20 December 2000, p. 10.

[18] The need for non-possessory security rights to promote commercial finance has been recognized in the EBRD model law, article 6 of which establishes a registered charge on movable property, without the need for possession, as one of its three principal charges.

[19] This approach is similar to that taken in article 9 of the EBRD model law. Under the model law, however, an unpaid vendor does not need to register its charge unless the vendor desires to have its charge continue to be effective against third parties for more than six months after its creation. See also paras. 55 and 56 below for a discussion of purchase-money security rights.

[20] A registration system is a cornerstone of the Unidroit draft convention on international interests in mobile equipment. In addition, the EBRD model law recognizes public registration of security rights.

[21] The ability to enforce one's security right in collateral efficiently through a non-judicial procedure is fundamental to most current and proposed multilateral security rights projects. For example, see article 8 of the Unidroit draft convention on international interests in mobile equipment and articles 22-24 of the EBRD model law. Under the latter, certain measures used to protect the chargeholder's property or provide for its disposition are available once the chargeholder delivers an enforcement notice pursuant to article 22, paragraph 2. This includes the right to take possession (art. 23, para. 1) and, after 60 days have elapsed, take title to and sell the property (art. 24).

[22] See *Official Records of the General Assembly, Fifty-fifth Session, Supplement No. 17* (A/55/17), para. 460.

[23] International Swaps and Derivatives Association, Inc., *Collateral Survey 2000*, pp. 11 and 61.

[24] *Official Records of the General Assembly, Fifty-fifth Session, Supplement No. 17* (A/55/17), para. 155.

[25] This used to be a major obstacle for most European countries. Following the implementation of the European directive for harmonization of trademark laws, as well as the enactment of the Community trademark, countries belonging to the European Union no longer require the goodwill to be transferred together with the trademark.

[26] So far, the most significant exception to this limit has been the establishing of the Community trademark, which vests the owner with an exclusive right extending to the whole territory of the European Community. A similar solution in respect of a Community patent right is expected to be established soon.

[27] See Trib. Vigevano, 2000, CLOUT case No. 378.

[28] See, for instance, the contractual choice of law provisions in the Unidroit draft convention on interests in mobile equipment/aircraft protocol. Under the draft UNCITRAL convention on the assignment of receivables in international trade, the assignor (secured debtor) and assignee (secured creditor) are free to choose the substantive law to govern the contractual aspects of their reciprocal rights and obligations.

[29] Article 9 of the Uniform Commercial Code of the United States, for example, leaves issues of "attachment [i.e. formal validity and transfer of a property interest as between the secured creditor and the debtor], validity, characterization (e.g. true lease or security interest), and enforcement" to the Code's general rules of private international law that would enforce the parties' choice of the law applicable to those issues if there is a reasonable relation of the jurisdiction chosen and the secured transaction.

[30] See, for example, the failed 1973 draft directive on the recognition of securities over movables without dispossession and of clauses providing for the retention of ownership upon sale of movables prepared by the European Commission.

[31] An intermediate solution is found, for example, in Canadian secured transactions legislation, which provides a limited "grace period" for foreign security rights after the goods are relocated into Canada (or relocated from one province to another within Canada). During the term of the grace period, the foreign security right is deemed to be effective against third parties (except certain bona fide purchasers) without having conformed to the local requirements, typically filing of notice in a public registry, required to make a domestic security right effective against third parties. To maintain its "deemed perfected" status, the foreign creditor must eventually comply with the requirements applicable to domestic security rights of the same kind (the grace period is typically 60 days). However, the grace period at least gives the secured party time to discover that the asset has been moved and to take steps to protect its rights under the new applicable law. (A similar approach was also taken in the United States until a recent revision substituted the law of the location of the debtor for the law of the location of the collateral to determine the law applicable to perfection of the security interest. Under the revised law, the grace period will apply to

changes in the location of the debtor rather than changes in the location of tangible property.)

[32] *Official Records of the General Assembly, Fifty-fifth Session, Supplement No. 17* (A/55/17), para. 459.